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**Sent:** Wednesday, March 30, 2005 9:35 AM

**To:** restructure.sizestandards@sba.gov

**Subject:** RIN 3245-ZA02 - Revised comments

Pasted in below are my revised comments. Please replace my earlier comments (March 25, 2005) with these revised comments.

Thank you,

Eugene (Gene) Watson

## **THE CASE AGAINST ALLOWING INELIGIBLE VC-OWNED BUSINESSES TO ENTER THE SBIR COMPETITION**

Let there be no doubt, allowing currently ineligible VC-owned businesses to enter the SBIR program will ultimately destroy the program.

### **FACTS**

It has been asserted by some that small businesses in which VCs have an investment are being denied participation in the SBIR program. This is not true. Small businesses in which VC's are minority owners ("VC-backed") have been eligible since the beginning of the program in 1982. Small businesses that are majority-owned and controlled by VCs ("VC-owned") were, until January 2005, ineligible to participate. Since then, they are also eligible if the parent VC organization is itself eligible. Small businesses that are majority-owned by ineligible VC organizations are not now and have never been eligible to compete for SBIR funding. These businesses are controlled by large well-funded financial entities, fully capable of addressing their own capital needs – and they have always been able to compete for the 97.5% of the federal extra-mural R&D budget that is not reserved for the SBIR program.

### **HISTORY**

In the 1970's, there was a growing national awareness that the nation's small businesses were the primary engine of technological innovation and new job creation. Yet, this under-resourced sector of the economy was severely limited in accessing federal R&D dollars, primarily because of the lack of the financial resources required to compete against large, well-financed organizations. In 1982, Congress addressed this issue by passing legislation authorizing the SBIR program. The program mandated that a very small fraction of the federal extra-mural R&D budget be set-aside for exclusive access by the nation's most innovative small businesses. This leveling of the playing field allowed small businesses with limited resources to compete only with their similarly under-resourced peers. In the ensuing 23 years, this program has well-served the national interest, enabling the small business sector to develop many important new technologies, and, most significantly, creating new jobs and improving

national competitiveness.

In 2004, the total SBIR annual budget exceeded \$2 billion for the first time, driven mainly by major increases in the extra-mural R&D budgets of two agencies, DoD and HHS, who together provide more than 85% of the total SBIR budget. For those who appreciate the principle of 'follow the money', it became obvious that this rapidly growing source of R&D funds would inevitably attract the attention of non-participating special interests. This walled-off 2.5% component of the federal R&D budget is especially attractive since, if breached, it would allow a few large, well-resourced entities to compete for SBIR funds against under-resourced small-business competitors – analogous to allowing the 'fox in the hen house'.

## ISSUE

In recent years, a small number of ineligible VC-owned businesses, encouraged by lax eligibility rule enforcement, began to participate in the SBIR program. When this growing practice became apparent in 2002-2003, the SBA Office of Technology notified the participating federal agencies of these violations and funding to the ineligible businesses was terminated. As it developed, a number of the terminated businesses are VC-owned biotechnology companies. In response, the VC and BIO industry lobbies have been pressuring Congress to pass legislation allowing all VC-owned small businesses to become SBIR eligible ("reinstated" as they erroneously describe it). As justification, these VC/BIO special interests have advanced the completely off-point argument that, since VC-owned businesses have (*illegitimately*) participated in the SBIR competition in the past, no harm will result by now legitimizing this practice. Surprisingly, this canard, even though demonstrably false, has gained traction. The SBIR funding process is a 'zero-sum' game - each grant award made to an ineligible participant is one less award available to the legitimate small business applicants.

VC-owned biotech companies have only recently become seriously interested in participating in the SBIR program, coincident with the advent (ca. 2001) of the questionable practice by some SBIR agencies of making 'jumbo awards'. The NIH began its practice of routinely exceeding the statutory award limits coincident with a doubling of its budget over a three or four year period. Apparently, the NIH was not administratively equipped to deal with this surge in funding and the jumbo awards were initiated, at least partially, to relieve this pressure. This practice has resulted in awards many times above the legislatively mandated Phase I and Phase II limits of \$100,000 and \$750,000, often by many millions of dollars. The harmful impact of this practice was only beginning to be apparent when the SBA cracked down on the participation of ineligible companies in 2003.

If allowed to continue, the practice of making jumbo awards will result in an ever-increasing crowding out of under-resourced small businesses from the SBIR competition - most current participants are too small to propose projects that could justify multi-million dollar awards. And larger awards means fewer awards, a very damaging outcome for the nation's small businesses, particularly for those in rural states having little or no VC investment activity. When a \$5 million Phase II award is made, six small businesses are denied the opportunity for a \$750,000 Phase II award. This practice crowds out those legitimate small businesses who

can't compete with VCs able to invest whatever it takes in assembling world-class teams to propose large scale projects (the 97.5% non-SBIR component of the federal extra-mural R&D budget is the appropriate funding source for such projects). The SBIR program was created to mitigate this gross mismatch. If ineligible VC-owned businesses are allowed to enter the SBIR competition, the level playing field the original SBIR legislation created would once again be tipped in favor of the financially well-endowed.

Another specious argument that has been advanced by the VC/BIO advocates is that VC-owned companies are more likely than their under-financed small business competitors to carry their innovations into commercialization. To the author's knowledge, no data exists to support this claim, and in any event, the argument is again off-point. The SBIR program created a level playing field so that under-resourced small businesses would compete exclusively with each other to develop their innovative concepts. Being denied access to the SBIR program does not inhibit VC-owned businesses from using their own, or other, capital resources to commercialize their own innovations. These activities should continue in parallel, not in an either/or manner.

A number of observers have pointed out that, in the 23 year history of the SBIR program, this is the first instance of a large special interest group seeking to be exempted from the SBA's affiliation rules. If the SBA allows large VCs to be considered as small business, then large universities, large non-profits and VCs formed by large corporations will not be far behind – bringing the 'camel's nose under the tent' metaphor to mind. Legitimate small businesses will then no longer have a tent of their own and the reasons for the SBIR program will no longer exist.

## **RESOLUTION**

Do not amend the Size Standards Affiliate rules to exempt ineligible VC-owned businesses, and, instead, require all agencies making un-mandated jumbo awards to discontinue this practice. In doing so, the VCs will lose interest in the SBIR program and the original intent of the program will be preserved. If the founding principles governing the SBIR program are abandoned, there will be no further need for the program.

## **“DON'T FIX IT – IT AIN'T BROKE!!!”**

I urge the SBA, the federal SBIR agencies and the Congress to defend and maintain the integrity of the SBIR program, thereby encouraging the nation's individually-owned, under-resourced small businesses to continue in their critical role of technology innovation and job creation.

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